Accounting Treatment of Interest on Deposits made out of Equity Share Capital and Interest Free Subordinate Debt Funded by Government

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company (hereinafter referred to as the 'company'), which is a joint venture between the Government of India (GOI) and the Government of Tamil Nadu (GOTN) has been incorporated for the implementation of chennai metro rail project (hereinafter referred to as the 'project'). The project will be implemented as a central sector project through the executing agency, viz., the company, which will work as a special purpose vehicle (SPV) for the implementation of project with the GOI and GOTN being the joint promoters with equal equity holding.
2. The estimated cost of the project is ₹ 14,600 crore and the same will be funded in the following manner:

(Rupees in crore)

Details	Means of finance for the project		
	Government of India	Government of Tamil Nadu	Total
Equity share capital	2,190	2,190	4,380
Subordinate debt (Interest free)	730	844	1,574
Senior term debt (Loan from Japan International Cooperation Agency (JICA))	8,646	-	8,646
Total	**11,566**	**3,034**	**14,600**

The funds are provided by the joint venturers for the purpose of construction based on the Government's budgetary provision. The Central Government, State Government and the company had entered into memorandum of understanding (MOU) for the purpose of execution of the project (a copy of which has been supplied by the querist for the perusal of the Committee).

3. The company is in the construction stage (*i.e.*, pre-commencement period). The company has appointed various contractors for the execution of the project. The Government releases amount towards equity and interest free subordinate debt by way of budgetary allocation. As per the MOU, any increase in the cost by way of price rise, rise in foreign exchange (forex) rate will be borne by the Central and State Government equally as equity.
4. The querist has stated that the company borrows money from Japan International Cooperation Agency (JICA). Loan agreement is executed between JICA and the Central Government (on behalf of the company). As per the loan agreement with JICA, the money can be borrowed by any one of the following ways:
   1. Commitment method
   2. Reimbursement method

   The company opted for the reimbursement method wherein the company initially makes payment to the contractor based on the running bills given by them and will then apply to JICA based on the payments made to contractors, the equity capital and subordinate debt being the source to fund the initial payments. JICA releases the money in JPY to the credit of Central Government on its receipt of application from the company. The Central Government releases the funds out of the JICA loan to the company as pass-through as per budgetary allocation. Interest and commitments payable on this loan are recognised in the books based on the funds released by JICA to the Central Government and the same is reconciled every year with AAAD (Aid, Accounts and Audit Division) statement maintained by the Central Government. The interest paid on the borrowing is taken as preoperative

expenditure and added to the capital work in progress (CWIP).

5. *Funds deployed by the company over the years:*
The equity and subordinate debts received from the Governments including the pass-through assistance of loan received from JICA, which are pending to be utilised for the project, are temporarily parked in short term deposits with the banks. The fund flow in the business for the last four years is tabulated below:

(Rupees in crore)

Particulars	2014	2013	2012	2011	2010	2009	2008
Equity including share application money –(a)	4141	3659	1919	999	262	50	50
Reserves and Surplus-(b)	244	164	76	5	3	0	0
Subordinate debt -(c)	1131	1082	968	886	841	500	500
Total-(a+b+c)=(d)	**5516**	**4905**	**2963**	**1890**	**1106**	**550**	**550**
Pass through received from GOI for JICA loan-(e)	4325	2582	1860	570	100	0	0
Excess of equity over debt-(d-e)	1191	2323	1103	1320	1006	550	550
Deposits at banks-(f)	1567	1300	1154	355	4	4	1
Interest earned from deposits during the year	124	131	104	5	1	0	0
Excess of equity over debt over deposits-(d-e-f)	**(376)**	**1023**	**(51)**	**965**	**1002**	**546**	**549**

6. *Sources of Income:*
The company earns income from various sources. Treatment of income and expenditure in the books are given below:

S. No	Source of Income	Accounting treatment in the books
1	Interest earned on bank deposits The company places deposits in banks out of the funds received in the form of equity capital, subordinate debt and reimbursements received on account of JICA loan pending utilisation.	The company did not prepare profit and loss account till F.Y. 2010-11. Interest earned on deposits till that year was adjusted against CWIP. From F.Y. 2011-12, the income earned is credited to the profit and loss account as the income earned on these deposits is not directly attributable to the project.
2	Sale of tender document The company charges fee on tender documents relating to project from the pre bid contractors	The income earned on sale of tender documents is directly attributable to the project. The income earned is shown as deduction from CWIP. There has been consistency in accounting treatment of income earned from the beginning.
3	Interest earned on advances provided to contractors The company provides advances to the contractors in the form of mobilisation advance, plant and machinery advance and special advance for the purpose of facilitation of work. The company charges interest on these advances from the contractors.	The income earned on these advances is shown as deduction from CWIP. There has been consistency in treatment of interest earned from the beginning.

7. *Query raised during Comptroller and Auditor General of India (CAG) audit:*
During the audit of F.Y. 2013-14, the CAG has raised a query that interest earned on these deposits is earned from the funds received as equity and also as per Accounting Standard (AS) 10, 'Accounting for Fixed Assets', income earned during the construction period should be deducted from the capital works and also stated that income should have been shown as deduction from expenditure to be capitalised. However, this has not been consistent with the

treatment in the past and the CAG had not raised any query on treatment of interest income.

B. Query

8. In light of the query raised by CAG, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment followed by the company in respect of the interest income earned on short-term deposits is in compliance with Accounting Standards.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting treatment of interest income earned on short term deposits out of the surplus funds received in the form of equity and debt for the implementation of Chennai metro rail project. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, treatment of equity and debt contribution by the Government of India and Government of Tamil Nadu, treatment of interest on JICA loan, propriety of not preparing statement of profit and loss till F.Y. 2010-11, disclosure of deposits by the company in its financial statements, treatment of fees on sale of tender document, treatment of interest earned on advances provided to contractors, accounting for prior period item, if any, to be reported in the current reporting period, etc. Further, the Committee notes from the Facts of the Case that with respect to loan from JICA, the company has opted for the reimbursement method wherein the company initially makes payment to the contractor based on the running bills given by them and then apply to the JICA for release of funds. Thus, a question may arise as to whether there would be any surplus funds out of loan from JICA. However, since the Committee is addressing the issue from the perspective of accounting principles and not from the perspective of determination of various amounts, this would not impact the opinion being expressed hereinafter.
10. The Committee notes that the company places deposits in banks out of the funds received in the form of equity capital, interest free subordinate debt and JICA loan pending utilisation. Thus, the source of investment consists of three categories, viz., equity capital, interest free subordinate loan and JICA loan. Therefore, the Committee has examined the treatment of interest income from these three sources separately.
11. With regard to treatment of interest earned on short term deposits made out of equity capital, the Committee notes the following requirements of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

    "9.1 The cost of an item of fixed asset comprises its purchase price, including… and any directly attributable cost of bringing the asset to its working condition for its intended use …"

    "10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

    From the above, the Committee notes that only those items of costs which are directly attributable to bringing the asset to its working condition can be included in the cost of an asset. The Committee is of the view that the same principle can also be extended in respect of an item of income arising during the acquisition/construction of an asset/project. Thus, only those items of income arising from the activities would go on to reduce the asset/project cost, that are directly attributable to the acquisition/construction of an asset/project for bringing it to its working condition for its intended use. In the extant case, the Committee is of the view that interest earned on short term deposits made out of equity portion is an income arising out of the company's ancillary activities which are not necessary to bring the project/asset to its working condition for its intended use and therefore, these cannot be considered as directly attributable to the rail project. Accordingly, interest income earned on the deposits made out of equity funds cannot be capitalised/included in the cost of the asset/project and therefore, should be recognised in the statement of profit and loss.

12. With regard to recognition of the interest earned on short term deposits made out of borrowed funds, viz., interest free subordinate loan and loan from the JICA, the Committee notes the definition of the term 'borrowing costs' and paragraphs 10 and 11 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the 'Rules', which state as follows:

> ***"3.1 Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds."***
>
> ***"10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.***
>
> 11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred."

The Committee notes from paragraphs 10 and 11 of AS 16 above that borrowing cost to be capitalised is to be adjusted with the income earned from temporary investment of borrowed funds while the project is in the stage of construction. Thus, the income earned during the construction period can be set-off only against the borrowing costs to be capitalised as per the principles of AS 16. Accordingly, in respect of a loan where no such borrowing costs as per AS 16 would arise, as in the case of interest free subordinate loan in the extant case, the interest income out of investment of such borrowed funds cannot be adjusted against the borrowing costs to be capitalised in the cost of the asset and the same shall have to be recognised in the statement of profit and loss.

13. With regard to income earned from the temporary investment of funds out of JICA loan during the period of construction, the Committee is of view that considering the principle discussed in paragraph 11 above, the said income should be adjusted against the borrowing costs to be capitalised as per the principles of AS 16 in the cost of the asset/project concerned.

D. Opinion

14. On the basis of the above, the Committee is of the opinion that the accounting treatment followed by the company in respect of interest income is not appropriate, as discussed in paragraphs 11, 12 and 13 above. Interest income from investment of surplus equity funds and interest free subordinate debt should be recognised in the statement of profit and loss and interest earned from investment of loan from JICA during construction period should be adjusted against the borrowing cost to be capitalised in the cost of asset/project concerned as per the principles of AS 16.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on January 16, 2015. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty two volumes. A CD of Compendium of Opinions containing thirty two volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.